Supreme Court, U.S.
FILED
OCT 4 1985
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-377

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM FRESCHI, JR.,
As Trustee of William Freschi Trust,

Petitioner,

v.

GRAND COAL VENTURE, ET AL.,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

NEAL SCHWARZFELD
(Counsel of Record)
SCHWARZFELD, GANFER & SHORE
Attorneys for Respondents
Grand Coal Venture, Ground Production Corp., Bandler & Kass, William J. Werner, Robert Sylvor, Jack Mitnick and H. Jean Baker
112 Madison Avenue
New York, New York 10016
(212) 686-9270

BEST AVAILABLE COPY

Merrill/Chicago • 372-2800

TABLE OF CONTENTS

	PAGE
TABLE OF AUTHORITIES	ii
STATEMENT OF THE CASE	1
REASONS FOR DENYING THE WRIT	5
ARGUMENT	5
POINT I	
THE SECOND CIRCUIT'S DECISION DOES NOT CONFLICT WITH DECISIONS OF OTHER CIRCUIT COURTS OF APPEAL AND IN LIMITED IN SCOPE	5
POINT II	
THE SECOND CIRCUIT'S DECISION CORRECTLY APPLIED SECTION 28(a) OF THE EXCHANGE ACT TO THE ISSUES IN THE CASE	7
POINT III	
THE SECOND CIRCUIT'S DECISION ON THE MOTION TO AMEND THE COMPLAINT TO ADD RICO CLAIMS WAS CORRECT ON THE FACTS	9
CONCLUSION	10

TABLE OF AUTHORITIES

Cases

	PAGE
Burgess v. *Premier Corp.*, 727 F.2d 826 (9th Cir. 1984)	6
Byrnes v. *Faulkner, Dawkins & Sullivan*, 550 F.2d 1303 (2d Cir. 1977)	8
Chasins v. *Smith, Barney & Co., Inc.*, 438 F.2d 1167 (2d Cir. 1970)	7
Fershtman v. *Schectman*, 450 F.2d 1357 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972)	8
Freschi v. *Grand Coal Venture* [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,204 (1985)	1
Glidden Company v. *Hellenic Lines, Ltd.*, 207 F.Supp. 262 (S.D.N.Y. 1962) *aff'd*, 315 F.2d 162 (2d Cir. 1963)	8
Green v. *Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969)	8
Harris v. *Standard Accident and Ins. Co.*, 297 F.2d 627 (2d Cir. 1961) *cert. denied*, 369 U.S. 843 (1962)	8
Levine v. *Seilon, Inc.*, 439 F.2d 328 (2d Cir. 1971)	8
Marbury Management, Inc. v. *Kohn*, 470 F.Supp. 509 (S.D.N.Y. 1979), *mod. on other grounds*, 629 F.2d 705 (2d Cir.), *cert. denied sub nom. Wood Walker & Co.* v. *Marbury Management, Inc.*, 449 U.S. 1101 (1980)	7, 8
Osofsky v. *Zipf*, 645 F.2d 107 (2d Cir. 1981)	8
Salcer v. *Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *petition for cert. pending* (No. 84-1447)	5, 9

	PAGE
Sedima, S.P.R.L. v. *Imrex Co.*, 53 U.S.L.W. 5034 (U.S. July 1, 1985)	11
Western Federal Corp. v. *Erickson*, 739 F.2d 1439 (9th Cir. 1984)	6
Statutes	
Securities Exchange Act of 1934	
Section 10(b)	1, 6, 8
Section 28(a)	7, 8, 9
Other Authorities	
C. MCCORMICK, *Damages* §121,449 (1935)	8
RESTATEMENT (SECOND) *Torts* §901 (1979)	8

No. 85-377

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM FRESCHI, JR.,
As Trustee of William Freschi Trust,

Petitioner,

v.

GRAND COAL VENTURE, ET AL.,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Respondents Grand Coal Venture, Ground Production Corp.,* Bandler & Kass, William J. Werner, Robert Sylvor, Jack Mitnick and H. Jean Baker respectfully request that this Court deny the petition for a writ of certiorari seeking review of the decision of the United States Court of Appeals for the Second Circuit in *Freschi* v. *Grand Coal Venture*, [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,204 (1985).

STATEMENT OF THE CASE

This is an action for damages, pursuant to Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) (the "Exchange Act") and Rule 10b-5 promulgated thereunder, brought by an investor in a tax sheltered coal exploration venture, alleging false and misleading statements in connec-

* Pursuant to Rule 28.1, Respondent Ground Production Corp. states that it has no parent, subsidiary or affiliated corporations.

tion with such investment. Plaintiff invested in the venture — Grand Coal Venture — in December, 1977, and paid $130,000 in 1977 and $136,500 in 1978 for the investment. The payments made in 1978 were in satisfaction of a series of recourse, interest bearing notes executed in 1977. Plaintiff, after the investment, claimed deductions of $520,000 for each of 1977 and 1978 from the federal and state income taxes due by the grantor of the plaintiff trust.* The Second Circuit, in its decision, held that plaintiff's investment was largely motivated by the tax sheltered aspects.

Respondents include Grand Coal Venture, Ground Production Corp., the entity that formed Grand Coal Venture and received the proceeds of the sale of its units, William Werner and Robert Sylvor, two attorneys instrumental in structuring the transaction, their law firm, Bandler & Kass, Jack Mitnick, the administrator of the venture, and H. Jean Baker, the president of a corporation that rendered a preliminary opinion as to the likelihood of discovering coal on the property.**

Prior to Petitioner's investment, Respondents Werner and Sylvor were counsel to Joseph Laird in connection with the sale by entities related to Mr. Laird of tax sheltered investments. When Mr. Laird, under pressure from the Securities and Exchange Commission ("SEC"), determined to cease his tax shelter business, Werner and Sylvor formed Spruce Productions, Inc. ("Spruce") as a vehicle to market a tax sheltered investment with respect to coal properties located in the state of Wyoming. The Spruce venture was, in most respects, designed to be substantially similar to the earlier Laird ventures.

---

* Under the trust instrument, all income earned was paid to the grantor of the trust, the father of the individual plaintiff, and the trust was not a separate tax paying entity.

** That corporation, Mineral Resources Development Corp., was defunct by the time the action was commenced in 1981 and did not appear.

However, in December, 1977, Mr. Laird and the entities affiliated with him consented to the entry of a temporary restraining order, simultaneously with the filing by the SEC of a complaint alleging the sale to the public of unregistered securities. Werner and Sylvor, although not parties in the SEC's action, determined to withdraw the Spruce offering and, after consultation with outside counsel, formed Grand Coal Venture. Grand Coal Venture was structured as a private placement under the SEC's then Rule 146, so as to avoid running afoul of the SEC's basis for its complaint against Mr. Laird, and was otherwise materially different from the proposed Spruce offering. For example, the state in which the coal properties were located was different and where, in Spruce, there had been express representations as to the quantities of coal to be available to the investors, in the Grand Coal Venture offering, there were numerous express written disclaimers as to the presence of *any* coal reserves.

The terms of the Grand Coal Venture offering were described in a more than 40 page Offering Memorandum dated December, 1977. This Memorandum repeatedly stressed that the offeror (Ground Production Corp.) could give no assurances of the presence of any coal reserves. Petitioner, who had examined the one page Spruce offering booklet, decided to invest in it primarily, he testified, because of its assurances of adequate coal reserves.* After the Spruce offering was withdrawn, Petitioner decided to invest in Grand Coal Venture — but, despite knowing that it had different terms than the Spruce offering, without reading the Offering Memorandum and without inquiring as to its terms.

The only communication Petitioner had with any Respondent prior to investing was a single telephone conversation with Mr. Werner. In that conversation, Mr. Werner is claimed to have told Petitioner that the Grand Coal Venture

---

* In Spruce, the offeror expressly agreed that, if the properties lacked sufficient coal reserves, substitute properties would be provided until sufficient coal reserves were obtained. No such agreement was contained in the Grand Coal Venture offering.

offering was essentially the same as Spruce and of having failed to advise Petitioner of the temporary restraining order that Mr. Laird had consented to as having been the reason for the withdrawal of the Spruce offering.* Significantly, there was no evidence that any other Respondent was aware of this conversation or of what was said in it.

In 1979, the trust grantor's tax returns were audited by the Internal Revenue Service ("IRS") and the deductions of $520,000 claimed for each of 1977 and 1978 were disallowed completely. Thereafter, the IRS agreed to settle its claim against the grantor by allowing a deduction of $266,500 to be taken for 1977. As of the date of the conclusion of the trial below, the 1978 tax returns were still open. The evidence at trial was that this 1977 deduction had an after tax value to Petitioner of some $188,500.

After a ten day jury trial, a verdict was returned against all Respondents, both for violation of Section 10(b) of the Exchange Act and for aiding and abetting such violation. The jury also found in favor of Petitioner on certain common law claims, not here pertinent. The jury rejected Respondents' arguments based on the statute of limitations, that there was no basis for liability against the Respondents who had no dealings with Petitioner, and that there was no basis for a finding of materiality, reliance or *scienter*. The jury awarded damages on the 10b-5 claims of $926,346.07, representing the tax deductions Petitioner was not able to claim by virtue of the IRS' disallowance of the claimed tax deductions. On Respondents' motion for judgment notwithstanding the verdict, the trial judge reduced damages to the actual amount invested ($266,500), but refused to take into account the value of the tax deductions actually afforded.** On appeal, the

---

* Although Mr. Werner testified to a very different conversation and to having told the Petitioner that Spruce had been withdrawn due to "SEC problems", the jury apparently did not credit such testimony.

** The Trial Court also granted in part Respondents' motion for judgment notwithstanding the verdict with respect to certain of the state law claims.

United States Court of Appeals for the Second Circuit affirmed as to liability** but reversed as to damages, holding, based on its prior decision in *Salcer* v. *Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *petition for cert. pending* (No. 84-1447), that tax savings had to be taken into account in calculating the amount of damages to be awarded. As a result, the damage award was reduced to $77,818.

REASONS FOR DENYING THE WRIT

Contrary to Petitioner's argument, the Second Circuit's decision was sharply limited to actions for damages in cases involving tax shelter investments. As a result, the Second Circuit's decision is not applicable to all suits for damages or to all 10b-5 actions. Additionally, due to the sharply limited scope of the Second Circuit's decision, Petitioner's claim of a split in the Circuits is erroneous. Finally, the writ should be denied because the decision of the Second Circuit correctly interpreted Section 28(a) of the Exchange Act.

ARGUMENT

POINT I

THE SECOND CIRCUIT'S DECISION DOES NOT CONFLICT WITH DECISIONS OF OTHER CIRCUIT COURTS OF APPEAL AND IS LIMITED IN SCOPE

In his attempt to persuade this Court to review the Second Circuit's decision, Petitioner has overstated the scope of the decision and has mischaracterized its impact. Thus, Petitioner seeks to create, and then refute, a decision barely resembling the actual decision of the Second Circuit.

First, Petitioner has overstated the scope of the Second Circuit's decision. Most importantly, contrary to Petitioner's arguments, the Second Circuit's decision is expressly limited

---

** The Second Circuit also reversed the verdict of 10b-5 liability as to Respondent Mitnick.

to the factual situation at issue, a damage action under §10(b) of the Exchange Act where the record indicates that the investment was motivated largely by the desire to obtain the tax shelter benefits. As a result, the decision is not applicable to all federal securities litigation. And, for this reason, the "serious adjudicatory problems" predicted by Petitioner (Petition at p. 12) are simply a chimera, since, as was true at the trial in this case, no complex computations of expected tax benefits is necessary in investments motivated by the desire to obtain tax shelter benefits.* Petitioners here bargained to obtain tax benefits, thus rendering the computations simple, yet complains when those tax benefits are taken into account.

Additionally incorrect is Petitioner's claim that the decision of the Second Circuit will leave purveyors of fraud with a windfall, since the Second Circuit's decision pertained only to damages on a Rule 10b-5 claim. Various remedies for numerous state statutory and common law claims were not affected by the decision.

Finally, Petitioner is simply incorrect that the Second Circuit's decision is inconsistent with decisions in other Circuits. The only decisions claimed by Petitioner to stand for the proposition that tax benefits should not reduce damages — *Burgess* v. *Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) and *Western Federal Corp.* v. *Erickson*, 739 F.2d 1439 (9th Cir. 1984) — are clearly distinguishable and are not inconsistent with the decision of the Second Circuit. Unlike the instant case, *Burgess* was a case where plaintiffs had been awarded actual rescission of their investment. *Western Federal*, which was not brought under Section 10(b) or Rule 10b-5, also involved an award of actual rescission. Where rescission is awarded, the parties are put in the position that would

---

* Petitioner's argument that the decision of the Second Circuit constitutes an incentive to commit fraud is similarly misplaced. There is no basis for concluding that limiting damages in tax shelter investments to the actual loss sustained will in any way impact on conduct of any persons connected to the tax sheltered investments.

have pertained had there been no investment at all — which includes recapture of any tax benefits already obtained.* As a result, where rescission is awarded, reducing damages by tax benefits obtained would *not* limit damages to those actually suffered but would reduce them to a lower amount, since the tax benefits would not be retained by the investor after rescission was affected.

Here, on the other hand, Petitioner chose to retain the investment in Grand Coal Venture and the accompanying tax deductions. Having made that choice, Petitioner seeks damages that would amount to allowing him to recover his anticipated profit (i.e., the tax benefits), a result prohibited by the Courts. *See, e.g., Chasins* v. *Smith, Barney & Co., Inc.*, 438 F.2d 1167 (2d Cir. 1970).

POINT II

THE SECOND CIRCUIT'S DECISION CORRECTLY APPLIED SECTION 28(a) OF THE EXCHANGE ACT TO THE ISSUES IN THE CASE

Apart from limited scope of the Second Circuit's decision and the fact that there is no conflict among the circuits with respect to the decision's holding on the issues involved in this petition, the Second Circuit's decision limiting Petitioner to actual damages under Section 28(a) of the Exchange Act was correct.

Section 28(a) of the Exchange Act limits the amount of damages recoverable for violations of the Exchange Act to "actual damages". It is well-established that "actual damages" are equivalent to a plaintiff's "net economic loss", *Marbury Management, Inc.* v. *Kohn*, 470 F.Supp. 509, 516

---

* Indeed, in *Burgess*, the Ninth Circuit expressly noted that, after rescission is effected, the plaintiff would be required to file amended tax returns reflecting the situation that would have occurred had the deductions never been claimed, and that, as a result, the previously claimed tax deductions would be lost.

(S.D.N.Y. 1979), *mod. on other grounds*, 629 F.2d 705 (2d Cir.), *cert. denied sub nom. Wood Walker & Co.* v. *Marbury Management, Inc.*, 449 U.S. 1101 (1980), and, where a plaintiff cannot show that he has suffered any actual pecuniary loss, his claim under Section 10(b) will be dismissed. See *Fershtman* v. *Schectman*, 450 F.2d 1357, 1361 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972); *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 335 (2d Cir. 1971).

The purpose of an award of damages in actions for fraud or deceit is "to place the plaintiff in the position he would have been in if the injury had not occurred." *Harris* v. *Standard Accident and Ins. Co.*, 297 F.2d 627, 631-32 (2d Cir. 1961), *cert. denied*, 369 U.S. 843 (1962); *Glidden Company* v. *Hellenic Lines, Ltd.*, 207 F.Supp. 262 (S.D.N.Y. 1962) (award of damages designed to reimburse, not to enrich), *aff'd*, 315 F.2d 162 (2d Cir.1963); C. McCormick, *Damages* §121, 449 (1935); Restatement (Second) *Torts* §901 (1979).

Accordingly, a failure to deduct all benefits received by a plaintiff would award the plaintiff a windfall which would be equivalent of an award of punitive damages. Section 28(a) prohibits any award of punitive damages. *Osofsky* v. *Zipf*, 645 F.2d 107 (2d Cir. 1981); *Byrnes* v. *Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977); *Green* v. *Wolf Corp.*, 406 F.2d 291, 293 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

In this case, the Second Circuit was guided by these established principles of law to conclude that, in the context of a tax shelter investment, damages sought by a plaintiff in a Rule 10b-5 action should be reduced by the value of the permanent tax saving he received from the investment.

Petitioners' arguments concerning the impact of the Second Circuit's decision on the eagerness of investors to file federal securities claims and the possible differences in damage awards for plaintiffs in different tax brackets ignore the

compensatory purposes of Section 28(a). As the Second Circuit stated, quoting its earlier decision in *Salcer, supra*:

> " . . . §28a of the Exchange Act [15 U.S.C. §78bb(a)] . . . limits plaintiffs to recovery of their actual net economic loss . . . . In applying §28(a) we cannot ignore the substantial economic tax benefits bargained for and realized by plaintiffs." (Opinion, App. A18).

POINT III

THE SECOND CIRCUIT'S DECISION ON THE MOTION TO AMEND THE COMPLAINT TO ADD RICO CLAIMS WAS CORRECT ON THE FACTS

Petitioner sought, on the eve of trial, to amend the complaint to assert claims under RICO. The District Court denied the motion and the Second Circuit affirmed.

Petitioner's proposed RICO claim did not separately allege any predicate acts, but merely incorporated by reference the underlying allegations of wrongful conduct. However, the only wrongful act found to have occurred was the making of misrepresentations and omissions in the single telephone conversation between Petitioner and Respondent Werner. All other communications, both oral and in writing, occurred *after* Petitioner's investment was completed. As a result, Petitioner could not have been injured by these post-transaction communications. And, the single pre-investment communication cannot constitute the necessary "pattern of racketeering activity" required in a RICO claim.

Accordingly, the Second Circuit's decision on the proposed RICO claims was plainly correct and was not inconsistent with this Court's decision in *Sedima, S.P.R.L.* v. *Imrex Co.*, 53 U.S.L.W. 5034 (U.S. July 1, 1985).

CONCLUSION

For the foregoing reasons, this Court should deny the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

NEAL SCHWARZFELD
(Counsel of Record)

SCHWARZFELD, GANFER
& SHORE
Attorneys for Respondents
Grand Coal Venture,
Ground Production Corp.,
Bandler & Kass, William J.
Werner, Robert Sylvor, Jack
Mitnick and H. Jean Baker
112 Madison Avenue
New York, New York 10016
(212) 686-9270

Dated: October 3, 1985